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SUBJECT: LITTLE HOPE FOR RUSSIA'S ATROPHIED INFRASTRUCTURE

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Classified By: ECON Minister-Counselor Eric T. Schultz, Reasons 1.4 (b/d).

Summary

11. (C) The GOR's stated commitments to modernizing and developing Russia's transportation infrastructure are unlikely to materialize soon. With a looming budget deficit, the government has cut infrastructure financing repeatedly. Some investment bankers argue that investing in infrastructure projects during the present crisis would take advantage of low input costs and employ laid-off workers, but it appears that only some high-profile projects, such as those connected with the Sochi Winter Olympic Games, are likely to receive government financing. Russia's inability to implement a coherent infrastructure strategy will hamper its chances of coming out of the crisis more economically competitive.

The Mirage of Infrastructure Improvement

12. (U) Since 2000, Vladimir Putin has regularly called for the modernization and development of Russia's neglected and dilapidated infrastructure. In November 2007, Putin stated that USD 1 trillion (80 percent of it to be supplied by private investors) was needed over the course of the next decade to achieve the goal. A year later, in October 2008, Putin vowed that infrastructure improvement would not be de-railed by the economic crisis. President Medvedev included infrastructure as one of his four "I"s (infrastructure, investment, innovation, institutions) in his Krasnoyarsk speech last February (reftel). Most recently, Presidential Aide Arkadiy Dvorkovich promised that infrastructure projects would be a key component of the GOR's anti-crisis measures. Most of the GOR's concrete efforts to date have been focused on road infrastructure, which is the prism we have used in our discussions with contacts. Rhetoric notwithstanding, few projects have gone beyond the planning stage.

13. (C) Contacts attribute the problem to the staggering infrastructure needs of Russia's vast territory combined with pervasive corruption at all levels of government and the elite. Paul Roger, Head of Infrastructure and Transport Research at RenCap noted that corruption in Russian construction was significantly higher than elsewhere. He estimated that in the U.S. about 5 percent of a project's

cost was eaten up by corruption, whereas the figure in Russia was about 10 percent. Moreover, in Russia, an additional 10 percent "gets lost", owing to inefficient project implementation and management -- for a total of about 20 percent.

14. (C) According to Alexander Shitov, Assistant Chair of the Industrial Policy Committee of the RF Chamber of Industry and Trade, the GOR's rhetoric has been intended to reassure Russians that infrastructure would be improved and that "tomorrow would be better". Shitov himself, however, doubted that any infrastructure improvements to Russia's industrial base would be undertaken in the foreseeable future. Sergei Drobyshevskiy of the Institute for the Economy in Transition also dismissed the GOR's stated infrastructure commitments. Citibank Public Sector Banking Head Andrei Mineev was equally pessimistic. Reviewing the GOR's current, and likely future, budget situation, he told us that more pressing needs such as supporting social expenditures would have to be met first.

The Realities of the Budget

15. (C) The GOR has been contradictory about its budgetary allocations for infrastructure. In January, the GOR almost halved the allocations of the Investment Fund for approved infrastructure projects from approximately USD 3.2 billion to USD 1.8 billion. (Note: The Investment Fund is the main vehicle that provides GOR contributions to infrastructure, among other things. Investment Fund contributions, however, are intended to be paired with private sector investment, which has dried up because of tight capital markets and Russia risk. End note.) On 4 February, First Deputy Prime Minister Igor Shuvalov announced further unspecified cuts to infrastructure programs in order to support the banking sector. The next day, Dvorkovich announced that government support for infrastructure projects would come second only to support for the labor market.

16. (C) Natasha Khanjenkova, Director of the Infrastructure and Energy Russia Business Group at EBRD, told us recently that although the GOR remains committed to infrastructure development, given budget constraints, it is now "looking much more carefully at which projects it will move forward with at this time". Out of the list of EBRD-related projects that Khanjenkova discussed, it appears now only two are still being actively considered: the expansion and modernization of St. Petersburg's Pulkovo Airport, which has a hard currency component and, as a public private partnership, continues to be viable, and the first part of the Moscow-St. Petersburg toll road, which would effectively provide Moscow with a toll road to Sheremetyevo Airport -- Aeroflot's hub.

Poor Infrastructure Costs Russia

17. (C) The costs of the crumbling roads are not insignificant. RenCap analysts have calculated that Russia's poor infrastructure costs its economy approximately six percent of its GDP per annum. This accounts for lost efficiency using decrepit assets and the lack of "connective infrastructure" that leaves over 40,000 towns and villages, housing about 12 million people, cut off from the rest of the country. Russia has only about one million kilometers of highways, of which about 5 percent are federal roads. Of those 50,000 kilometers, only 40 percent are considered "normal". Experts estimate that it needs about 2 million kilometers, all of which should be "normal". RenCap's Paul Roger also noted that Russia's roads were approximately 48 percent depreciated.

18. (C) There are regional disparities as well. Our interlocutors in the retail, auto, and warehousing sectors have all told us that since Russia is essentially cleaved in two at the Urals and the majority of the population lies west of them, marketing and expansion strategies focus on European

Russia, thereby excluding Siberia and the Far East. As Avtomir's Vladimir Petrov told us, it is pointless to even consider a true car dealership network in Asian Russia since there are fewer roads and fewer people every year.

"Silver Lining" of Crisis?

¶9. (C) Despite the government's lack of initiative, there are some analysts who hold hope that the GOR will take advantage of the crisis to address Russia's pressing infrastructure needs. RenCap's Paul Roger, for instance, argued that the crisis would encourage the government to channel more resources into large public works projects such as road construction as a means to provide jobs, and he predicted that a condition of government-financed infrastructure projects would be that construction firms use Russian labor instead of (cheaper) migrant labor, which has comprised road construction crews to date. Moreover, Roger emphasized that the Sochi Olympics and the Vladivostok 2012 APEC Conference would be finished because it was a "matter of pride" -- Russia would want to show its best face to the world at these events. Indeed, the government has been at pains to reassure IOC officials that Sochi-related infrastructure projects will be unaffected by Russia's budget woes.

Comment

¶10. (C) The few infrastructure projects that are likely to be undertaken will probably not do much to boost Russia's economic growth. Moreover, addressing Russia's growing unemployment problem with a New Deal-type infrastructure initiative seems unlikely. The continued inability of the GOR to implement a coherent strategy for infrastructure development and modernization will be another important obstacle to Russia's coming out of the crisis stronger and more competitive economically. End Comment.
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